

## Options for business rate reform

Since the 1990 reforms to local government finance, business rate levels have been set by central government. Recent research by Kevin Denny, John Hall and Stephen Smith of the Institute for Fiscal Studies shows that there would be a number of different ways of restoring local control over business rate levels, with very different implications.

- f** Restoring local control over business rate levels would increase the proportion of local spending financed from revenues under local control from the current 18 per cent to around 44 per cent, making local government less dependent on central government grants.
- f** Simply restoring the pre-1990 business rate arrangements is no longer possible, since other elements of the system of local government finance have changed, especially the basis for allocating central government grants.
- f** Allowing local authorities to keep business rate revenues collected in their area would require changes to the allocation of central government grants to local authorities. Otherwise large differences would arise in local household and business tax rates, just because the amount of business rateable value differs between areas.
- f** The effect on council tax would vary with the proportion of extra spending that business taxpayers contributed: if this were set at 15 per cent (roughly the proportion of local spending that benefits business), the impact of the change on council tax levels would be small; if set at 60 per cent (roughly the pre-1990 situation), there would be a large reduction in council tax levels in high-spending areas.
- f** Setting the proportion at 60 per cent would increase non-domestic rates by about 4 per cent - from an average of 42.3 pence in the pound to 43.9.
- f** The 'resource equalisation' between local authorities which would need to be provided through changes to central government grants need not be as extensive as that before 1990; partial equalisation arrangements would also be possible. Even with full equalisation, however, the range of business rate poundages would be considerable: some would be less than 37 pence in the pound, whilst the highest would be above 55 pence.

### Pros and cons of business rate reform

Local control over business rate levels was abolished as part of the 1990 reforms to local government finance. Since these reforms, a uniform business tax rate ('rate poundage') has been set nationally and, although local authorities continue to administer business rates, the revenues are pooled and distributed to local authorities in proportion to their population. Business rates have become, in effect, a national tax, from which the revenues are earmarked to local government.

There continues to be pressure to return to the earlier system, where the tax rate was under local control. There are three main grounds for advocating a return to local control; however, there are counter-arguments to these:

- *The yield from business rates has fallen sharply since 1990: could this be because the incentive for local authorities to collect the tax has been weakened, now that they simply receive a share of the pooled business rate revenues?*

Much of the fall in business rate yields experienced in recent years is due to the recession; there is no reason to believe that local control would have had any effect on this. In addition, local authorities still have a clear financial incentive to collect business rates, since the amount they must contribute to the business rate pool depends on local rateable value not on the amount actually collected.

- *A very high proportion of local authority revenue is obtained from a central government grant based on a standard assessment of what the Local Authority should spend - the Standard Spending Assessment (SSA). If actual spending is different from this, the difference is made up by changing the local tax rate. Because the local tax is such a small proportion of total revenue, a small difference between the SSA and the actual spend can lead to large percentage changes in the amount of local tax that must be collected. This may blur local authority accountability since council tax rates have become highly sensitive to changes in the formula used to calculate SSAs. A broader local tax base (with the restoration of business rates to local control) would reduce the impact of grant changes on council tax rates. Some argue that reducing both the amount of instability in council tax levels caused by grant changes and the dependence of local government on central government transfers would enhance local democratic accountability.*

The report suggests that additional local taxes (such as a local income tax) might be better than business rates as a way of broadening the local tax base. However, restoring local control over business rates would be easier to introduce.

- *The 'nationalisation' of non-domestic rates may have weakened the relationship between local authorities and businesses. In the current system, local authorities which attract business by spending on*

*services benefiting business do not gain any extra tax base. Also, the need for business to talk to local government has been reduced, since local spending decisions no longer feed through to taxes on business.*

The report contends that this line of argument often reflects a misunderstanding of the pre-1990 position, where, due to resource equalisation, local authorities gained no resource benefit from attracting extra business.

In addition, there are important disadvantages to local control, which prompted the 1990 introduction of the uniform business rate. In particular, differences in business rate levels between local authority areas could lead to distortions in the geographical pattern of business activity and investment. The evidence on this in the UK - which relates, of course, to the period before 1990 - is limited. Whilst the pre-1990 system led to considerable differences in the potential profitability of locating an investment in different areas, there was little systematic statistical evidence that business rates distorted the location of business investment and employment. The effects of location are hard to identify due to the very long time-frame within which they take place. Recent research by IFS shows that in the short term business rates may not greatly affect the profitability of the current occupant. Distorting effects would only arise in the long term, when new premises were being built.

### Designing a new system

There are a number of ways of restoring business rates to local control, with widely-varying effects. Simply restoring the pre-1990 business rate arrangements is no longer possible or logical because the local government finance system differs now in two important respects:

- The current basis for allocating central government grants involves more limited resource equalisation than under the pre-1990 system; it provides local authorities with sufficient resources to ensure that they can all levy the same tax rate if they spend at the standard level (SSA), but does not equalise at other spending levels. The inequity which thus arises is, perhaps, tolerable where differences between areas are related to the council tax base only, but the system has not been designed to cope with the much greater resource differences between authorities' business rate tax base.
- Before 1990 local household taxes were levied on the same base as business rates, and (with the exception of a small discount through domestic rate relief) a common tax rate applied to both business and domestic local taxpayers. The system, in effect, operated as a single local tax and the amount that should be contributed by local business taxpayers followed as a natural consequence of the relative size of the business and domestic rate bases. Since domestic rates have

now been abolished, there would be two separate local taxes if business rates were restored to local control; explicit decisions would have to be taken as to the relationship between the two taxes.

These two differences suggest, in turn, two key areas where choices need to be made in designing a system for restoring some measure of local control over business rates.

- How much equalisation is required to offset differences in the business rate tax base between areas and on what basis should the equalisation be made? Would some form of simplified partial equalisation be adequate or is it necessary to have full resource equalisation for business rates on the pre-1990 model?
- What should business contribute to overall local government resources?

There is a wide range of possible choices about these key issues; the research explored the implications of four possible schemes:

**Model 1.** Full equalisation of the business rate base, with a given percentage contribution by household tax payers (council tax payers).

**Model 2.** Full equalisation of both tax bases, with the increase in the rates of council tax and business rates proportional to the size of local authorities' spending above the SSA.

**Model 3.** Partial equalisation, with a fixed business share. Resources are equalised for spending at SSA, but local taxpayers pay for

additional local spending, regardless of the local tax base.

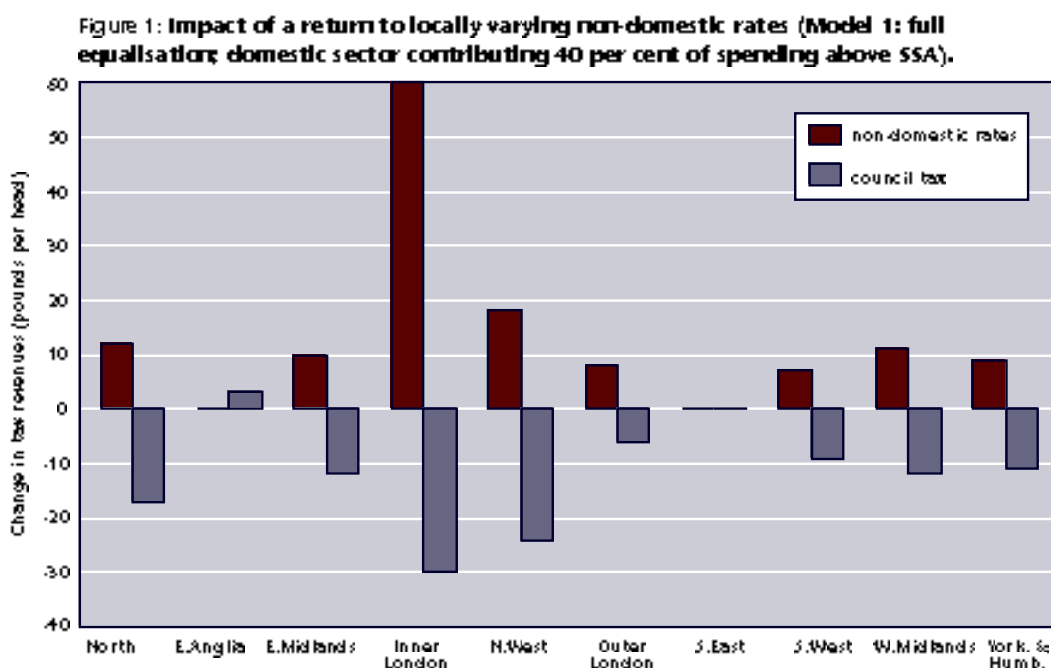
**Model 4.** Partial equalisation, with varying business share. Again, resources are equalised for spending at SSA, and local taxpayers pay for additional local spending, regardless of the local tax base. However, in this case, the contribution of business ratepayers varies according to the importance of business (measured by employment) relative to household taxpayers (measured by numbers of residents).

#### The effects on local taxpayers

The full report assesses the impact of these reforms on local taxpayers, using budget data for each local authority in England in 1994/95. The impact of Model 1 (full equalisation, with 60 per cent of marginal spending financed by the non-domestic sector) on local tax payments by business and household taxpayers is illustrated in Figure 1.

Key results include the following

- If the business sector is required to finance 60 per cent of spending above the SSA, non-domestic rate poundages would rise by slightly more than 1 penny in the pound - from an average of 42.3 pence in the pound to 43.9 pence in the pound.
- Even with full equalisation of the business rate base, the range of business rates poundages would be considerable: some authorities would set tax rates at less than 37 pence, whilst the highest rates would be greater than 55 pence.



- Special arrangements would be needed for the City of London. Despite having only about 5,000 residents, the City has more non-domestic rateable value than the entire Northern Region of England.
- Restoring local control over business rate levels would reduce council tax rates in authorities where local spending is higher than the SSA. The effect on council tax bills would depend on the contribution to spending above the SSA demanded from the business sector and on other features of the model adopted. Model 4, where local taxpayers pay the full cost of extra spending in each authority with the burden distributed across authorities according to the relative 'size' of the domestic and non-domestic sectors, would give a particularly large advantage to households in areas with a large amount of taxable business.
- In the full equalisation models, the largest reductions in council tax payments per head of population would be in inner London (council tax bills would fall by some £30 per head) and the North West (falls in council tax of about £20 per head). There would be little if any change in council tax levels in East Anglia and the South East (the areas where there is least excess of spending over SSA).

The report also considers two more extensive reforms to non-domestic rates.

The first reform moves to a 'multi-base' tax, broadening the local business tax base to include a payroll element as well as rateable value with the aim of reducing the bias against capital which arises in the current non-domestic rating system. A local business tax based on payroll as well as rateable value would impose a more evenly-spread burden across different sectors of business; it would also reduce the differences between local authorities in levels of business taxation, compared with a system of locally variable business rates. However, this reform would considerably reduce the proportion of revenue contributed by businesses in greater London and increase the proportion contributed by the rest of the country. The redistribution of tax burdens resulting from the multi-base tax would make it difficult to implement. Moreover, it is not at all clear that the present system does have a serious bias against capital, since labour also bears heavy taxes, for example, employers' National Insurance contributions.

The second reform would introduce variable rates within the business sector, by setting a lower rate for certain kinds of business, such as manufacturing or retailing. The report argues that this would be a poorly targeted way of assisting firms in difficulty. Also, if the tax burden on certain sectors is reduced, then the tax rate applying to other sectors would have to rise to maintain a constant overall revenue yield.

#### About the study

The report uses budget data for each local authority in England in budget year 1994-95 to model the pattern of local finances and local tax rates under each of four options for locally varying business rates, and under two alternative 'wider' reforms. The estimates assume that the 1994-95 pattern of local authority spending would be unaffected by the reform. For each authority, the allocation of central government grant is calculated, to reflect the arrangements for resource equalisation under each option, along with the revenue required to be raised from local business taxation and the council tax.

#### Further information

Further details are available in Options for Business Rate Reform by Kevin Denny, John Hall and Stephen Smith (IFS Report Series) available from the Institute for Fiscal Studies, 7 Ridgmount Street, London, WC1E 7AE; Tel: 0171 636 3784, Fax: 0171 323 4780 (Price £10 inc p&p).

#### Related Findings

The following *Findings* look at related issues:

- 5 Alternatives to the community charge (Dec 90)
- 6 Attitudes to the community charge (Jan 91)
- 7 The community charge in Scotland: the second year (Jan 91)
- 11 A new tax for local government (Jun 91)
- 17 Options for a local income tax (Jul 92)
- 25 The effect of Standard Spending Assessments (Oct 93)
- 26 Implementing the Council Tax (Apr 94)
- 31 The operation of the non-domestic rate (Nov 94)
- 32 The feasibility of a local sales tax (Jan 95)

For further information on these and other *Findings*, call Sally Corrie on 01904 654328 (direct line for publicatoin enquiries only).



Published by the  
Joseph Rowntree Foundation  
The Homestead, 40 Water End  
York YO3 6LP  
Tel: 01904 629241 Fax: 01904 620072  
ISSN 0958-3823

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